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An overview of recent developments in employee benefits.(executive compensation, health and welfare plans and fringe benefits.)(part 2)

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including qualified and nonqualified retirement plans, welfare benefits and executive compensation. Part I, in the last issue, addressed general developments in retirement plan qualification requirements and employee stock ownership plans. Part II, below, focuses on general developments in executive compensation, health and welfare plans and fringe benefits. this two-part (Employee Benefits & Pensions)

EXECUTIVE SUMMARY

* The IRS addressed AMT treatment and deduction issues stemming from the exercise of NQSOs.
* Sec. 4980B final regulations provide guidance on COBRA coverage-continuation requirements.
* The IRS updated the model grantor trust for nonqualified deferred-compensation arrangements for the new Sec. 1032 regulations.

Executive Compensation

Withdrawn Parachute Ruling Request

An IRS legal memorandum to the Chief of the Examination Division described the facts and law involved in a withdrawn letter ruling request under Sec. 280G. (30) The taxpayer had requested three rulings:

1. The waiver of market-based restrictions on the exercise of stock options held by the taxpayer's executives would not constitute a parachute payment due to accelerated vesting.

2. The calculation of the contingent portion of the taxpayer's stock options vested on account of the merger is performed under Prop. Regs. Sec. 1.280G-1, Q&A-24(c), taking into account only the service restriction on the options.

3. Q&A-24(c) applies to any lump-sum payments received by the taxpayer's executives on account of a change of ownership or control that served as a substitute for amounts they would have received had they continued to work for the taxpayer.

The taxpayer withdrew the ruling request on being informed that the IRS was prepared to issue an adverse ruling on all three requests.

Law: Sec. 280G prevents an employer from deducting "excess parachute payments." Sec. 4999 imposes a 20% excise tax on the recipient of an excess parachute payment. "Parachute payments" are payments in the nature of compensation to (or for the benefit of) a disqualified individual (e.g., an officer, shareholder or highly compensated employee (HCE)) if the (1) payment is on account of a change on ownership or control of a corporation and (2) present value of the contingent payments equals or exceeds three times the individual's average taxable compensation for the last five years (the "base amount").

A payment to a disqualified individual is rebuttably presumed to be

contingent on a change of control if made under an agreement (or amendment) entered into within one year before a change of ownership or control. Only the excess portion of a parachute payment is subject to adverse tax treatment.

Prop. Regs. Sec. 1.280G-1, Q&A-24(c), reduces a parachute payment by the value of any payments the disqualified person was "reasonably certain" to have received absent the change in control.

The memorandum stated that Q&A-24(c) was included in the proposed regulations to reduce the contingent portion of a nonvested payment partially earned by the taxpayer with services, but unpaid. The legal memorandum also stated that this does not occur with amounts under an employment agreement (which are paid as earned).

Proposed ruling: The IRS informed the taxpayer that it had been prepared to rule that:

* The market-based exercisability restrictions on stock options issued to executives caused the options to be "unvested." The waiver of the restrictions resulted in parachute payments on accelerated vesting of the options, due to a change of control.

* The payments due to the accelerated vesting of the options cannot be reduced under Q&A-24(c).

* Q&A-24(c) does not apply to any lump-sum payments made on a change of control that are severance payments.

The memorandum concluded: "We bring this matter to your attention so that you may take whatever action, if any, you deem appropriate." Generally, taxpayers who undertake the expense of applying for a letter ruling are seeking guidance and assurance and place the IRS on notice as to the nature of their transaction. It is difficult to see why a taxpayer would withdraw a letter ruling request on notice of a proposed adverse opinion, then complete the transaction. This is what the memorandum seems to be telling the IRS district office. The IRS appears to be issuing a warning to the public about completing a similar transaction. Possibly, more formal guidance could not be published for internal reasons.

Parachute Payment Valuation

In Letter Ruling 200110025, (31) an executive was constructively terminated after a change in control and received a payment equal to his salary and bonus for the remainder of his employment agreement. The IRS held that this payment would not be valued under Prop. Regs. Sec. 1.280G-1, Q&A-24(c), which provides that a reduced amount is included in the parachute payment amount. The IRS also held that a reasonable payment established by clear and convincing evidence under a noncompete agreement is not a parachute payment.

Executive was the president of Target Company (Target), wholly owned by Corporation A. Executive had an employment agreement (Agreement) with Target that provided a minimum annual salary and bonus; the Agreement was to run through a specified date. The Agreement provided that for the term of the Agreement and for 12 months following the end of Executive's employment with Target, Executive could not compete directly or indirectly with Target.

Parent Company made an offer to acquire Corporation A. After the acquisition, Executive's job duties were to change and he would be required to move to a new location. Executive invoked a provision of his Agreement to treat the changes in employment as a termination. Under the Agreement, Executive received an amount equal to his current salary and bonus multiplied by the Agreement's remaining term. A ruling was requested as to whether the parachute payment made to Executive on the change in Target control could be reduced by Prop. Regs. Sec. 1.280G-1, Q&As-11 and -24(c).

Law and analysis: Sec. 280G provides that a deduction is not allowed for an excess parachute payment. Q&A-11 provides that certain types of payments are deemed compensation for the performance of services and can be included as parachute payments. Under Q&A-11, the performance of services includes refraining from performing services (e.g., under a covenant-not-to-compete or a similar arrangement). If a taxpayer establishes by clear and convincing evidence that an amount attributable to a noncompete covenant is reasonable, the payment will not qualify as a

parachute payment under Sec. 280G(b)(2)(A). The IRS held that a reasonable amount attributable to refraining from performing services under the noncompete covenant would not be a parachute payment under Sec. 280G(b)(2)(A).

Q&A-22(c) provides that a payment that would have been made had no change in control occurred is treated as contingent on a change in control if the change accelerated the time at which payment was made. However, the payment might be significantly reduced under Q&A-24(c) if it was substantially certain at the time of the change that the payment would have been made without regard to it had the disqualified individual continued to perform services for the corporation for a specified period.

Q&A-24(c) reduces the contingent portion of a nonvested payment partially earned by the taxpayer with services, but unpaid. The IRS stated that Q&A-42(b) correctly governs payments made under an employment agreement; it provides that amounts paid as damages for a breach of contract may be reasonable compensation for personal services to be rendered on or after the date of the change in control, if certain requirements are met. Further, Q&A-44 provides that severance payments are not treated as reasonable compensation for personal service actually rendered before (or to be rendered after) the change in control.

In the ruling, the IRS held that the amounts paid under the Agreement substituted for the compensation Executive would have earned had he continued to perform services for the remainder of the contract term and did not qualify for the Q&A-24(c) reduction.

This ruling evidences no change in the Service's position. The IRS has long held that the performance of services under Sec. 280G includes refraining from performing services. Also, a reasonable value (established by clear and convincing evidence) attributed to a noncompete covenant is not a parachute payment. The important issue is the ruling on Q&A-24(c). In the past, taxpayers have aggressively argued that payments similar to those in this ruling made under an employment agreement could be valued using Q&A-24(c). Letter Ruling 200110025 evidences the IRS's position on this issue.

Rabbi Trust Guidance

In Notice 2000-56, (32) the IRS updated the model grantor trust for nonqualified deferred-compensation arrangements for the new Sec. 1032 regulations. (33)

Many employers establish nonqualifled deferred-compensation plans ("top hat" plans) for their top executives. While these plans are unfunded, unsecured liabilities of the employer, it is not unusual for an employer to set aside money in a grantor trust (a "rabbi trust") to help pay for the benefits as employees retire. The rabbi trust assets remain the employer's property for tax purposes and are available to the company's creditors in case of insolvency. In certain cases, a subsidiary establishes a rabbi trust for its own executives and includes parent stock as one of the trust assets.

Regs. Sec. 1.83-6 provides that if a shareholder transfers company stock to company employees, the stock is treated as a capital contribution to the company; any payment back to the shareholder may be a dividend. However, new Regs. Sec. 1.1032-3 addresses the corporate treatment of transfers of parent stock to a subsidiary. Under the "cash purchase" model in Regs. Sec. 1.1032-3 (b) and (c), if parent shares are received by the subsidiary and are immediately transferred to employees, the subsidiary is treated as having (1) received cash from the parent to purchase the stock and (2) purchased the stock from the parent at fair market value (FMV). Thus, the subsidiary has no gain or loss on the transaction.

Typically, funding a rabbi trust with parent stock would not meet the "immediate transfer" rule, because the parent stock is contributed long before the amounts are paid to employees. Thus, the subsidiary would recognize gain on the stock transfer to the employees when they retire or otherwise receive distributions.

Immediate-transfer rule: Notice 2000-56 sets forth a method by which a subsidiary can meet the immediate-transfer rule:

* The parent contributes parent stock to a rabbi trust to assist in meeting the subsidiary's plan obligations.

* Parent stock is subject to the claims of the parents creditors.
* Parent stock not transferred to employees on trust termination will revert to the parent.

If these requirements are met, the parent is treated as the grantor and owner of the parent stock (even if the assets are also subject to the subsidiary's creditors' claims). When the stock is finally transferred to the employees, it will be treated as if it were immediately transferred to the subsidiary and then to the employee, meeting the immediate-transfer requirement.

Former Executives' Compensation Not Subject to Sec. 162(m) Limit

The IRS ruled that corporate officers who resign with no intent to resume employment are not "covered employees"; thus, their pay for that year will not be subject to the Sec. 162(m) deduction limit. (34)

A wholly owned subsidiary merged into a publicly traded company. After the merger, the acquired company was no longer publicly traded and will not file a Securities Exchange Commission (SEC) "summary compensation table" disclosing the pay of its chief executive officer (CEO) and four highest-paid officers under the Securities Exchange Act of 1934 (Act). Some of the officers of the acquired corporation will resign before the last day of the tax year at issue.

Law: Sec. 162(a)(1) allows a deduction for ordinary and necessary business expenses, including reasonable salaries, but Sec. 162(m) limits the salary deduction to $1 million for "covered employees." Regs. Sec. 1.162-27(c)(2) defines a covered employee as any person who, on the last day of the tax year, is the CEO (or is acting as such) or is among the four highest-paid corporate officers other than the CEO. Determinations are made under the Act's executive compensation disclosure rules.

The preamble to the proposed Sec. 162(m) regulations explains that the regulations specifically provide that, to be a "covered employee," an individual must be employed as an executive officer on the last day of the tax year. Thus, only employees who appear on the summary compensation table and are employed on the last day of the tax year are covered employees.

Ruling: The IRS held that, assuming that the summary compensation table was not required by the Act from the acquired corporation for the merger year, the acquired corporation's officers will not be covered employees for that year. The IRS also ruled that the officers of either corporation will not be covered employees under Sec. 162(m) in the year they resign, if they resigned their employment or their positions as officers before the last day of that year with no intention to return as officers for the foreseeable future. Compensation paid to them will not be subject to the Sec. 162(m) deduction limit.

This ruling clarifies the IRS's position on the Sec. 162(m) definition of covered employee. Although the ruling cannot be cited as precedent, the authorities on which it is based can be cited.

Life Insurance Rate Table

Rev. Rul. 55-747 (35) provided bases to compute one-year term insurance premiums in determining the amount required to be included in employee income from current life insurance protection provided under a whole-life or endowment insurance contract held by a qualified plan. The "P.S. 58" rates set forth in Rev. Rul. 55-747 were based on mortality tables first published in 1946; these rates are also used for split-dollar arrangements. Notice 2001-10 (36) provides a new table (ending at age 99, instead of 75) with substantially lower rates.

Rev. Ruls. 66-110 (37) and 67-154 (38) permit a plan (or split-dollar arrangement) to use an insurance company rate lower than that shown in the Rev. Rul. 55-747 table under certain circumstances; they are not materially changed by Notice 2001-10 and are still valid. Taxpayers may continue to use the rates in Rev. Rul. 55-747 for tax years ending before 2002.

The new rates are substantially lower than the old. Over the years, the old rates had become an upper limit on the term insurance value includible in plan participants' incomes. The new tables will save having to obtain insurance company rates in computing the cost of term insurance includible in participants' incomes.

Split-dollar life insurance: Notice 2001-10 contains rules on

split-dollar life insurance polices (especially those provided in the course of employment) and certain other life insurance valuations. The valuation issues may affect (1) split-dollar life insurance policies given to others and (2) qualified retirement plans' purchases of life insurance.

Employers frequently provide split-dollar life insurance policies for their top executives. Sometimes the policies are intended as part of a deferred-compensation plan (or in lieu of one); sometimes they are simply another employee benefit. These are generally whole-life contracts under which the employer pays the premiums and the employee agrees to pay back the premiums to the employer out of the policy's cash-surrender value. In some cases, the employee owns the policy and collaterally assigns it to the employer (generally up to the value of the premiums paid). In other cases, the employer owns the contract and endorses some beneficial ownership interest to the employee.

P.S. 58 costs: Based on Rev. Ruls. 64-328 and 66-110, employers have not generally treated any portion of a split-dollar life insurance contract as employee compensation. Instead, the employee paid (or took into income) an amount that approximated the value of the term life insurance provided under the contract. In these rulings, the IRS suggested using a table in Rev. Rul. 55-747 for valuing the annual cost of term life insurance ("the P.S. 58 cost"). In addition, the IRS permitted employers to use the value of an insurance company's "published term insurance rate" instead of P.S. 58 costs.

P.S. 58 costs are added to employee wages if an employee chooses to have life insurance protection purchased within a qualified retirement plan. In addition, P.S. 58 costs have occasionally been used to determine the value of certain types of charitable gifts (e.g., the portion of a charitable gift that acts like term insurance for the donor). The values used in determining the P.S. 58 costs are long out-of-date; they are based on mortality tables from the mid-1940s.

Sec. 83: TAM 9604001 (39) suggested that Sec. 83 applied to split-dollar life Insurance contracts. Sec. 83 governs the transfer of property to an employee (or independent contractor) in connection with the performance of services. Sec. 83 transfers are taxable compensation once they are not subject to a substantial risk of forfeiture. The TAM generated many comments from industry groups (mostly disagreeing with the IRS's position).

Interim guidance: Notice 2001-10 is interim guidance that can be relied on until further guidance is issued. The notice institutes new valuation methods for split-dollar contracts. Under the new rule, (1) the P.S. 58 cost tables have been repealed and replaced with newer tables; and (2) employers and others can continue to use "published term insurance rates," but with clarifications about which rates can be used.

The notice also offers employers two choices in treating split-dollar life insurance contracts--as loans under Sec. 7872 or as compensatory property transfers under Sec. 83 (to the extent employees derive certain "economic value").

Valuing life insurance protection: The rates published in Notice 2001-10 are significantly lower than the original rates. The reduction may significantly reduce the value of life insurance included in income for split-dollar life insurance and qualified-plan purposes. Under the notice, this new rate is available immediately, but the old P.S. 58 rates can generally be used until the end of 2001 to value the income inclusion to employees.

Term rates: The IRS has been concerned that certain insurance companies had "published term insurance rates" for valuation purposes not generally available to the public. Much like previous letter ruling guidance, Notice 2001-10 provides the rules for term rates. The insurance company must generally comply with all three of the following:

* Make the availability of the rate known to individuals who apply for term insurance through normal distribution channels.
* Sell term insurance at such rates to such individuals.
* Not more commonly sell term insurance at higher premium rates to individuals classified as standard risk.

Loan rules: If an employer treats premium payments as an employee

loan (or series of loans), the employer either has to collect interest or impute it (generally using an applicable Federal rate under Sec. 7872). The imputed amount would be reported as compensation on Form W-2, which could be expensive. In the case of split-dollar insurance contracts, there will be no Sec. 83 issues unless the employer forgoes repayment.

Under Notice 2001-10, this approach cannot be used for existing arrangements unless the employer and employee have consistently treated the arrangement as a loan.

Collateral-assignment rules: If the employee originally applies for and "owns" the insurance contract, but collaterally assigns a portion to the employer, different rules apply.

First, as under the old rules, the employee will have to pay or have included in taxable income the value of the term life insurance policy (either under the new tables or under the term insurance rates discussed above). Second, the employee will have to take into income any dividends paid under the contracts, if the dividends are paid to him or used to increase policy benefits. Third, the employee will have Sec. 83 compensation if he obtains a vested interest in the policy's cash-surrender value (less any amount paid by the employee for that right and less any increase in the cash-surrender value due to interest or earnings on employer premiums). In most contracts, the increase in the cash-surrender value is due almost entirely to the payment of premiums and to earnings thereon. Thus, it appears that very little of the typical contract will be subject to Sec. 83 at this time.

However, the notice indicates that the increase in the cash-surrender value is arguably a transfer of value to the employee. The notice carefully states that, at this point, the IRS will not treat such increases as Sec. 83 transfers--but does suggest the possibility of doing so in later guidance.

For now, employers need not do anything significantly different with typical collateral-assignment contracts. Employers may want to report dividends as Form W-2 wages (if they do not already) and may want to check with their life insurance providers to compare the proper term insurance rate with the new P.S. 58 cost.

Reliance: The treatment of the typical split-dollar life insurance contract is not appreciably different based on this notice. However, some language raises concern that the IRS eventually will try to treat all such arrangements as employer loans to the employee (with significant imputed income on the premiums' value).

Notice 2001-10 can generally be relied on until further guidance is issued, which will be prospective only.

Reporting and Disclosure Obligations for Sec. 457(b) Plans

Notice 2000-38 (40) clarifies reporting and withholding obligations for Sec. 457(b) plans.

Sec. 457(b) governs large state and local government deferral plans for rank-and-file employees. Certain tax-exempt employers also use Sec. 457(b) plans for their top-level people (not as common; often, Sec. 457(f) plans are used). Sec. 457 plans are somewhat like Sec. 401(k) plans, in that some state and local governments allow their employees to enter into salary-reduction agreements, funding contributions through the employee's salary. However, Sec. 457(b) plans technically are nonqualified deferred-compensation plans; thus, they are not governed under the regular pension rules.

In 1996, Congress mandated that all Sec. 457(b) state and local government plans establish masts by 1999, and made other changes that brought these plans closer to Sec. 401(k) plans. Because Sec. 457(b) plans are nonqualified, some employers and benefits advisers have been concerned about the filing and income tax reporting requirements. Specifically, questions have been raised over the years about the applicability of FICA, especially the early payment of FICA under the Sec. 3121(v) rules. Also, some employers were not sure that distributions were reported on Form W-2 or the party responsible for reporting (e.g., plan trustee, employer or custodian). Finally, consultants have asked the IRS whether a Sec. 457(b) plan is required to file Form 990, Return of Organization Exempt from Income Tax, or Form 990-T, Exempt Organization Business Income Tax Return

(and proxy tax under section 6033(e)).

Guidance: Notice 2000-38 provides detailed guidance on each of these issues, including:

1. The employer has a Form W-2 reporting obligation (or a Form 1099-R reporting obligation, for death benefits paid from a plan).

2. The employer, trustee or custodian (whoever has control of the assets) has a Federal income tax withholding and payroll tax obligation on distributions from Sec. 457(b) plans.

3. The employer must report withholding on Form 941, Employer's Quarterly Federal Tax. Return, or the trustee, custodian or insurance company needs to report the withholding on Form 941 using an employer identification number for the trust (or for the aggregate trusts).

4. Sec. 3121(v), requiring early payment of FICA (as of the later of when the contribution is earned by the employee or becomes vested), applies to Sec. 457(b) plans to the extent that FICA applies to the employee.

5. A state or local government plan trust for a Sec. 457(b) plan need not file annual information returns on Form 990.

Notice 2000-38 also provides that a Sec. 457(g) mast may be required to file Form 990-T. It is not clear when this requirement would apply to a state or local government plan.

FICA and Federal Income Tax Withholding on Options

Notice 2001-14 (41) offers guidance on the payroll tax and Federal income tax withholding requirements for incentive stock options (ISOs) and Sec. 423 plans. These requirements have long been contested, with the IRS taking various positions. In the last year, certain IRS agents have been pursuing FICA and income tax withholding on both ISOs and Sec. 423 plans. Sec. 423 plans allow employees to purchase employer stock at a pre-selected time at a discount up to 15% of FMV.

Generally, a nonstatutory or nonqualified stock option (NQSO) is compensation under Sec. 83 and is subject to FICA, FUTA and income tax withholding on exercise (a separate rule exists for stock options with a readily ascertainable value when granted, a fairly unusual occurrence). Sec. 421 provides special tax rules for "statutory options" (ISOs under Sec. 422 and Sec. 423 options).

Under these rules, an employee is not subject to income tax when the stock is exercised (although the spread may be subject to alternative minimum tax (AMT)); the tax is generally determined when the stock is sold. If the stock is sold after the statutory holding period has passed (generally, the later of two years from grant or one year from exercise), the gain is not ordinary compensation income, but capital gain.

If the stock is sold before the end of the statutory holding period (a disqualifying disposition), the "spread" (i.e., the FMV less the exercise price) at exercise is compensation income; any remaining gain is capital.

The discounted portion of a Sec. 423 option (the discount below FMV at grant or exercise (often a 15% discount)) is compensation income when the stock is sold, even if the employee holds the stock for the statutory holding period.

Rev. Rul. 71-52 (42) provided that ISOs were not subject to FICA, FUTA or income tax withholding, even after a disqualifying disposition. Notice 87-49 (43) provided that this conclusion was being reconsidered, but that employers could rely on Rev. Rul. 71-52 until further notice. For many years, the IRS position has been that the value of a Sec. 423 plan option is subject to FICA (but not income tax withholding) at exercise. More recently, the IRS has taken the position that Rev. Rul. 71-52 does not apply to Sec. 423 plans.

Interim rules: In Notice 2001-14, the IRS states that, although the tax rules exempt the exercise of statutory options from income tax, Congress never excluded the value of statutory options from FICA or FUTA. As other types of income are excluded from income but not FICA (e.g., Sec. 401(k) elective deferrals), the IRS believes that Congress intended for the spread to be included in FICA and FUTA, apparently at exercise. However, because of the confusion caused by the prior revenue rulings and notices, the IRS will not enforce a new position until 2003. The IRS takes the following positions as to statutory stock options exercised before 2003:

* FICA, FUTA and Federal income tax withholding will not be assessed on exercise.
* Federal income tax withholding will not be assessed on a disqualifying disposition of a statutory option.
* While not clear in the notice, based on independent discussions with the IRS, FICA and FUTA may not be assessed on a disqualifying disposition (presumably, additional guidance will be provided).

Notice 2001-14 clarifies the IRS's position and takes the least burdensome approach. The approach is less onerous than the IRS position on option exercise under a Sec. 423 plan. In the notice, Treasury and IRS suggest that, without statutory authority, they cannot waive the imposition of FICA or FUTA on such options.

Reporting Stock Option Compensation

The IRS announced that a new code will be used on 2001 Form W-2 for employers to report income from an employee's NQSOs. (44)

Traditionally, employers reported the difference between the stock price on date of exercise and the exercise price (the "spread") on Form W-2 in boxes 1, 3 and 5. Beginning with 2001 Form W2, the compensation from option exercise must still be reported in those boxes, and must be reported in box 12. A new code, "V" will be used to identify this type of compensation. The IRS later provided that use of Code V is optional for 2001 Form W-2s. (45)

AMT and E&P on NQSOs

The IRS addressed AMT treatment and deduction issues stemming from the exercise of NQSOs. (46)

If a company transfers stock on exercise of an option granted in connection with the performance of services to which Sec. 421 does not apply (i.e., a NQSO), and the option did not have a readily ascertainable FMV at the time of grant, the company's earnings and profits (E&P) are reduced by the deduction allowed the company under Secs. 82(h) and 162 for such exercise. Because this reduces E&P, the deduction is not disallowed under Sec. 56(g)(4)(C)(i) in computing adjusted current earnings for AMT purposes.

Breach-of-contract Damages

The Third Circuit upheld a district court decision on valuing damages to an officer wrongfully denied the right to exercise his stock options. (47) The court held that the damages would equal the spread on the day the officer had attempted exercise.

In 1995, US Wats, Inc. (Company) hired Scully as president under a two-year contract and granted him options for 850,000 shares of restricted stock (with an exercise price of $0.75 per share). The shares could not be transferred for one year from the purchase date. The options would vest over the two-year employment period. The options were granted under the Company's 1993 executive stock option agreement (1993 plan); all options expired on employment termination. During Scully's term as president, the 1993 plan was amended by a 1996 plan, under which employee options would expire 30 days after termination from the company.

The Company granted more stock options than were available; some of the options needed to be eliminated before Dec. 31, 1996. If not eliminated, the 1996 SEC filing would reveal an excessive number of granted options. The Company developed a plan to eliminate several of the outstanding options and decided to replace Scully before the end of 1996. The Company told Scully he would remain employed through the rest of his contract so that he would not immediately attempt to exercise his options. However, the Company decided to fire Scully without notice so he would not have time to exercise his options before termination, allowing the options to expire.

On Dec. 30, 1996, Scully was terminated without warning, effective immediately. In January 1997, he attempted to exercise his option to purchase 600,000 shares (which closed that day at $1.375 per share), representing his entire vested amount. The Company would not allow the exercise. The additional 250,000 shares would have vested on May 1,1997.

Scully sued the Company for breach of contract. The district court found that Scully had been wrongfully terminated and deprived of his stock options; it awarded damages equal to the spread on 850,000 shares on Jan.

23,1997, the day Scully was denied the right to exercise them.

Wrongful termination: On appeal, the most difficult issues for the court were Scully's attempted exercise of the stock options and the damages. The court found that the district court had correctly reasoned that the Company could not reject Scully's attempt to exercise his stock options, because the Company had wrongfully breached the employment contract.

Conversion v. breach of contract: Having decided the wrongful-termination issue, the court had to decide whether the district court had properly determined damages. Scully argued that his damages should have been calculated at the end of the restricted period, because only then could he have sold all the shares. (They were trading at a much higher price at the end of the restricted period and would have given him substantially more damages.) The Company claimed that although the district court's valuation date was proper, it incorrectly valued the option by failing to apply a discount to FMV for the restricted shares' lack of marketability.

The appeals court reviewed two competing damages theories--conversion and breach of contract. The conversion theory provides that damages are intended to compensate an individual for actual loss. Conversion damages are based on lost profits, by comparing the individual's exercise price to the greater of the (1) value of the stock at conversion or (2) highest intermediate stock price between the notice of conversion and a reasonable time thereafter during which the stock could have been replaced.

The breach-of-contract theory's goal is to put the individual in the same position he would have been in had the breach never occurred. Under this approach, damages are calculated as of the date of the breach by taking the difference between the option exercise price and the stock's market price at the time of breach.

Both theories assume that an individual can mitigate damages by purchasing the lost shares. While the conversion theory does not reward a party for wrongful behavior, it is very generous to a wronged individual and assumes that he would have sold at the market highpoint. The breach-of-contract theory avoids any uncertainty concerning the amount of future profit or loss, but also fails to consider the benefit the individual had with the options and the prospect of future profits.

Conclusion: The court ruled that, given the variety of factors that can arise, it doubted a single damage theory would properly value stock options in all situations. Thus, the Third Circuit agreed with the district court's damage calculation, because the latter properly weighed and balanced the strengths and weaknesses of the competing damage calculation methods to put Scully in a position that closely reflected the one he would have been in had the breach not occurred. By relying on the breach date and measuring damages from the date Scully was willing to risk his money, the district court avoided the speculation and hindsight problems that arise from the conversion theory.

Excess Benefit Plan Not Ambiguous

The Second Circuit ruled that an excess benefit plan's specific language overrules the general language found in its purpose clause. (48)

Aramony was president and CEO of United Way of America from 1970-1992. In 1992, his employment contract was terminated amid allegations of fraud. In 1995, Aramony was convicted of numerous felony counts of fraud, and sentenced to seven years.

During his tenure as United Way president, aramony had been covered under its qualified defined-benefit plan and a nonqualified replacement-benefit plan (RBP). The issue was whether the RBP would replace qualified-plan benefits lost by reason of the enactment of a lower Sec. 401(a)(17) compensation limit by the Tax Reform Act of 1986 (TRA '86). The parties agreed that the RBP covered qualified-plan benefits lost because of TRA '86's reduction of the Sec. 415 benefit limit and Rev. Rul. 80-359's (49) holding excluding deferred compensation from the definition of compensation under qualified plans.

The RBP statement of purpose provided that the plan was to provide a way to secure pension benefit promises to management and HCEs whose

qualified plan benefits could be reduced by Code-imposed limits. The plan's operating provisions specified a particular formula for calculating the contributions required to replace the benefits lost due to Rev. Rul. 80-359 and sec. 415. Sec. 401(a)(17) was not mentioned in the plan.

District court holding: Aramony argued, and the district court agreed, that because the plan's broad purpose clause conflicted with its narrow operating clauses, the plan was ambiguous. The district court then looked to evidence outside the plan to establish its meaning. Because the defendant was funding a benefit sufficient to provide Aramony with compensation for his benefit reduction under Sec. 401(a)(17), the district court held for the executive in the amount of $1.3 million.

Second Circuit decision: The Second Circuit found the RBP plan to be unambiguous, precisely laying out the benefits to be replaced and the formulas for doing so. It relied on the principles of contract law to interpret the RBP. Under those principles, "whereas clauses" cannot create rights--they can only help interpret a document. The court found that the RBP's purpose clause served the same function as a contractual whereas clause and could not be read to create rights.

Transfer of Profits Partnership Interest Nontaxable

The IRs issued guidance on the tax treatment of the grant of a substantially nonvested partnership profits interest in exchange for the performance of services to the partnership. (50)

Health and Welfare

Final COBRA Regs.

Sec. 4980B final regulations provide guidance on Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) coverage-continuation requirements. The final regulations supplement 1999 COBRA final regulations and adopt the 1999 proposed regulations. (51) The regulations are generally effective for events occurring after 2001.

Small-employer-plan exception: Under Regs. Sec. 54.4980B-2, Q&A-5, if an employer has fewer than 20 employees, its group health plan is not subject to COBRA. Employers can count part-time employees on either an aggregate or individual basis when determining eligibility for the exemption.

Determination of plan number: The final regulations reorganize the rules for determining the number of plans that an employer or employee organization maintains. Regs. Sec. 54.4980B-2, Q&A-6, provides that the default rule (i,e., that all healthcare benefits provided by one entity or trade or business are treated as one plan)applies unless it is clear from the governing instruments that the benefits are being provided under separate plans. This rule revises the 1999 proposed regulations by requiring that the arrangement be operated under the instruments as separate plans to avoid the default rule.

Health FSAs: The final regulations refer to Sec. 106(c)(2) in defining a health flexible-spending arrangement (FSA). The proposed regulations had cited to Sec. 125, but new Sec. 125 regulations use the Sec. 106 definition.

Regs. Sec. 54.4980B-2, Q&A-8, clarifies that, to the extent a health FSA is obligated to make COBRA continuation coverage (CCC) available to a qualified beneficiary, all the general CCC rules apply in the same way as they do to coverage under other group health plans (including a rule for how plan coverage limits apply to COBRA participants).

Premium increase: Regs. Sec. 54.4980B-4, Q&A-1 (c), maintains the rule defining a loss of coverage in determining whether a qualifying event has occurred. If a qualifying event results in an increase in the coverage premium or contribution, there is a loss of coverage. This rule was maintained so that a person whose premium was increased would be entitled to both a 60-day election period and a 45-day post-election period to make the first premium payment.

Moving outside region: Under the 1999 final regulations, employers and employee organizations were required to make alternative coverage available to qualified beneficiaries moving outside the service area of a region-specific benefit package. Regs. Sec. 54.4980B-5, Q&A-4, clarifies that an employer must provide alternative coverage no later than the date of the qualified beneficiary's relocation (or, if later, the first

day of the month following the month in which the qualified beneficiary requests alternative coverage).

Coverage effective date: The 1999 final regulations provided that for indemnity or reimbursement arrangements, claims incurred during the election period did not have to be paid before the election was made. Regs. Sec. 54.4980B-6, Q&A-3, provides that, in the case of indemnity plans and reimbursement arrangements that allow retroactive reinstatement of coverage, coverage can be terminated, but reinstated later (when the election is made). Thus, the rules for coverage reinstatement and claims payment are now the same.

Insignificant underpayments: The 1999 final regulations addressed how plans treat COBRA payments short by an insignificant amount. Plans are required to treat a payment as a full payment, unless the plan notifies the qualified beneficiary of the amount of the deficiency and grants a reasonable period for payment. Regs. Sec. 54.4980B-8, Q&A-5, states that an underpayment is insignificant if it is not greater than the lesser of (1) $50 or (2) 10% of the required amount.

Reorganizations: The final regulations adopt the proposed regulations on business reorganizations, with two clarifications. The proposed regulations provided that in an asset sale, the purchaser is deemed a successor employer if the seller ceases to provide any group health plan to any employee in connection with the sale and the buyer continues the business operations associated with those assets without substantial change or interruption. Regs. Sec. 54.4980B-9, Q&A-8(c)(1); specifies that this rule also applies to assets purchased in bankruptcy. Under the final regulations, a buying group is still deemed a successor employer in connection with an asset sale, if the sale occurs in connection with a bankruptcy proceeding. Asset sales include sales as well as other transfers.

Employer withdrawals from multiemployer plans: The final regulations retain the 1999 proposed regulations' general approach. However, the proposed rules required that an employer who stops contributing to a multiemployer plan must make CCC available only if it establishes a new plan to cover active employees covered under the multiemployer plan. Regs. Sec. 54.4980B-9, Q&A-10, applies the general approach to existing and new plans.

For a withdrawing employer, the proposed regulations required that the employer or subsequent multiemployer plan cover a significant number of the employer's employees formerly covered under the multiemployer plan. Regs. Sec. 54.4980B-9, Q&A-10, provides that the employer plan (or subsequent multiemployer plan) must offer CCC once coverage under the plan is available to a class of employees formerly covered under the multiemployer plan. The employer's obligation does not arise until the employer makes coverage available; the multiemployer plan would be responsible for CCC until the waiting period under the employer's plan has expired for a class of employees formerly covered under the multiemployer plan.

COBRA and FMLA: Regs. Sec. 54.4980B-10 states that the end of Family Medical Leave Act of 1993 (FMLA) leave is not determined under the COBRA regulations, but under Department of Labor (DOL) regulations. (52)

DOL Treatment of Welfare Plan Demutualization

The DOL issued guidance on the treatment of stock received by a welfare-benefit plan (or by an employer on the plan's behalf) in the demutualization of an insurance company. In an unnumbered lettered dated Feb. 15, 2001, the DOL provided practical solutions to the problems faced by welfare-benefit plans receiving stock under a demutualization. This letter was issued in conjunction with two companion letters to the same law firm dealing with other Employee Retirement Income Security Act of 1974 (ERISA) issues arising from the demutualization.

ERISA protects plan assets in company-offered health, dental, life insurance and other welfare-benefit plans offered to employees. ERISA Section 403(a) provides that contributions to a welfare-benefit plan must be placed in a trust. However, ERISA Section 403(b) provides an exception for plans that provide benefits through the purchase of insurance; no trust is needed for premiums that can be paid directly to an insurance company.

Thus, many small employers have no need for a trust for their welfare-benefit plans.

A mutual life insurance company allows policyholders to be part owners of the company, but does not issue stock to them. A company that undergoes a demutualization process issues stock to these policy owners.

If a welfare-benefit plan has paid premiums to a mutual company and will receive stock as part of a demutualization, the plan may have plan assets subject to the trust requirements. If both employers and employees have paid premiums, a portion of the plan assets must be placed in trust under ERISA Section 403(a). Because the plan may own only a small amount of stock, the trust may exist only for a short period. In many cases, the trust will not be tax-exempt (unless the employer requests an exemption letter under the voluntary employee beneficiary association (VEBA) rules). Thus, the employer may have to establish a trust under local law and report the trust income for Federal and state tax purposes, even though the plan assets may last only for a short time.

As part of a large demutualization, a company asked the DOL to waive the trust requirements for welfare-benefit plans receiving stock from a demutualization. The DOL confirmed that the trust rules technically apply to a demutualization, but suggested that the rules can be avoided by having the insurance company keep the shares as advance premiums or use them to pay for plan enhancements.

More importantly, the DOL agreed to waive enforcement of the trust and applicable reporting rules if certain criteria were met. The DOL would waive enforcement because the ownership of plan assets is a "one-time, unintended consequence" of having elected a mutual insurance company. The DOL believes the cost and burdens involved in complying with the trust rules may significantly outweigh the benefits to participants of having the money in a trust. To avoid the trust and reporting rules, a company must satisfy all of the following conditions:

1. The plan is not otherwise required to maintain a trust.
2. Plan assets must consist solely of the proceeds received in the demutualization.
3. Cash must be placed in an interest-bearing account in the plan name; stock must be placed in a custodial account in the plan name.
4. Plan assets must be under the control of a designated plan fiduciary.
5. The fiduciary must maintain documents and records as to assets.
6. As soon as reasonably possible (but no later than 12 months following receipt), the assets are to be (i) used to pay participant premiums; (ii) used to enhance plan benefits; or (iii) distributed to plan participants.

The advisory opinion did not specifically address the allocation of returned benefits among plan participants. However, in a companion letter, (53) the DOL provided that the allocation of amounts returned under a demutualization must be done in a fair manner. The DOL noted a duty of impartiality; the selection of an allocation method that favors the fiduciary (as a plan participant) at the expense of other participants is inconsistent with this duty. Likewise, the use of one plan's assets to benefit the participants of another may be a breach of the duty of loyalty to plan participants.

While the DOL letter does not address tax issues, there has been some concern as to the tax treatment of amounts paid back to participants as a post-demutualization return of premiums. In most cases, employees paid these premiums with pre-tax contributions to Sec. 125 cafeteria plans. Returns of premiums paid through a cafeteria plan are generally taxable distributions treated as wages and reportable on Form W-2.

Another area that the DOL did not address is the possibility of penalties if plan assets are not used for a plan purpose. Sec. 4976 assesses a 100% penalty on any direct or indirect reversion from a"welfare benefit fund" to the employer starting the fund (defined in Sec. 419(e) as any trust (taxable or not) or "to the extent provided in regulations, any account held for an employer by any person"). Temp. Regs. Sec. 1.419IT, Q&A-3(c), states that an "account" with an insurance company could be a "fund."

Although the DOL letter is not a regulation, it is an official pronouncement and the only guidance an employer can rely on when placing demutualization stock into an account rather than a trust. The IRS could attempt to apply the Sec. 4976 penalty to amounts that should have been used for benefit purposes (which can include giving the participants a refund or premium holiday), but that reverted to the employer.

Excess VEBA Contributions Were Dividends

In a test case, excess contributions to life insurance plans formed under a VEBA plan were dividends to employer-participants and were deductible only to the extent the contributions funded term life insurance. (54)

The VEBA was formed by insurance salesmen to encourage sales of life insurance and other insurance products purchased through VEBAs. The VEBAs were marketed to professional small-business owners as a viable tax-planning strategy. The VEBAs were not designed, marketed or purchased for an employer to provide welfare benefits to employees.

Each employer-participant contributed to his own plan formed under the VEBA; each plan provided that a covered employee would receive term life insurance for the current year. The premiums charged were significantly higher than the actual cost of such insurance, because the premiums funded both the cost of the insurance and credits,to be applied to conversion universal-life policies for the individuals insured. The credits were "earned" on the policy over 120 months. The policyholders could withdraw or borrow against any earned amount without out-of-pocket expenses. Thus, the credits were available to employees at any time. The employers took deductions for the full premium amounts.

The taxpayers argued that their contributions to the VEBAs were deductible, because the contributions were paid as compensation to fund an employee fringe benefit (i.e., term life insurance). The IRS conceded that the premiums needed to buy term insurance were deductible, but argued that the excess premiums were disguised distributions of surplus cash, not ordinary and necessary business expenses. It argued further that the excess contributions were not being used to buy current term life insurance, but were. dividend distributions to the corporate shareholders covered under the plan.

Analysis: The Tax Court agreed with the IRS. From the opinion's tone and length, it appears that the Tax Court is very intolerant of VEBA cases involving tax-advantaged estate planning devices. In addition to losing the deductions on the additional payments, the taxpayers were liable for accuracy-related penalties for their negligence or intentional disregard of the rules or regulations and for failure to file timely returns. The Tax Court did allow a deduction for the cost of current term life insurance premiums.

Fringe Benefits

Transportation Benefits

Salary reductions for qualified transportation fringe benefits are to be treated the same as cafeteria-plan salary reductions for purposes of the Sec. 415 limits, retroactively effective for all years beginning after 1996 (as if included in the Taxpayer Relief Act of 1997 (TRA '97)). (55)

Sec. 415 (c) limits contributions and other additions to defined-contribution plans to the lesser of $35,000 (in 2001) or 25% percent of compensation. Sec. 415 (c) (3) generally defines compensation in determining whether contributions satisfy the limit. Sec. 415(c)(3)(D)(ii), added by the TRA '97, provides that a "participant's compensation" includes amounts contributed or deferred by the employer at the employee's election that are includible in the employee's gross income under Sec. 125 (cafeteria plans) or 457 (plans of state or local governments or tax-exempt organizations). The general definition did not include amounts reduced from pay under Sec. 132(f) for qualified transportation fringe benefits.

Further, Sec. 414(s), which determines whether a definition of compensation is discriminatory under plans qualified under Sec. 401(a), previously did not address Sec. 132(f).

Secs. 415(c)(3)(D)(ii) and 414(s)(2) were amended to include in the definition of compensation amounts deferred and not includible in employee gross income due to qualified transportation fringe benefits under Sec.

132(f)(4).

Qualified Transportation Fringe Benefits

Sec. 132(f) final regulations (56) address qualified transportation fringe benefits and ensure that transportation benefits provided to employees are excludible from gross income. Unlike many fringe-benefit rules, the qualified transportation rules are also affected by outside factors (primarily, the mass-transit authorities, who seek to encourage employers to buy transportation passes).

Changes from proposed regs.: Generally, the final regulations retain the general substance and structure of the 2000 proposed regulations, with modifications and clarifications based on comments received.

Mass transit: Under Regs. Sec. 1.132-9, Q&A-9-16, the one-percent test continues to be used to determine whether a voucher for transit passes is "readily available." A voucher is readily available if an employer can obtain it for no less favorable terms than an employee and without incurring significant administrative costs (i.e., in excess of one percent of the vouchers' average monthly value). However, internal administrative costs are excluded from the one-percent threshold. The test applies to years beginning after 2003.

If multiple vouchers are available for distribution to employees, the employer must use the lowest-cost voucher in determining whether administrative costs cause the voucher not to be readily available. However, if multiple vouchers are necessary to meet the area's transportation needs, the employer can average the costs in making the determination.

Nonfinancial restrictions can cause vouchers not to be readily available, including a voucher provider not making vouchers available at reasonable intervals, in reasonable quantities or denominations.

Transit passes can be provided in advance for more than one month (e.g., quarterly). If transit passes are provided in advance, but the recipient ceases to be an employee before the end of that period, generally, the value of the transit pass is excluded from wages for employment tax purposes, but not for income tax purposes.

Qualified parking: "Qualified parking" includes, under Regs. Sec. 1.1329, Q&A-4, parking on or near a work location at which an employee provides services for an employer, but excludes reimbursement of parking otherwise excludible from gross income because paid from an accountable plan. Also excluded is parking provided to an employee and excludible from gross income as a working-condition fringe benefit under Sec. 132(a)(3).

Deduction of Vacation Flights on Corporate Jet

In a case of first impression, the Eighth Circuit upheld a Tax Court decision that an employer could deduct the costs of executives' vacation flights on a corporate jet, because the executives treated the vacation flights as wages. (57)

Sutherland Lumber (Sutherland) owned and maintained a corporate jet used primarily for business travel. The company's president and vice president used the jet for both business and vacation travel and reported any use not for business purposes as compensation. Sutherland calculated and reported the imputed income under Regs. Sec. 1.61-21(g).

Sutherland deducted its costs incurred in operating the jet under Sec. 162, including the vacation flights. The IRS disallowed the deduction for the vacation flights as a form of entertainment expense. The IRS argued the deduction was limited to the compensation the executives reported.

Sec. 162(a) provides that a taxpayer can deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business and expenses paid as compensation for personal services. If the compensation is paid in noncash fringe benefits, the employer can deduct expenses incurred in providing the benefit if the value of the noncash fringe benefit is includible in the recipient employee's gross income. The employer cannot deduct the amount included by the employee as compensation, but rather the costs incurred in providing the benefit.

Tax Court's decision: The court considered whether, under Sec. 274, a taxpayer may deduct its aircraft operating costs in full or is limited to the amount reported as compensation by employees. Sec. 274 was enacted to curb abuses of business expense deductions for travel, entertainment and

gifts. Sec. 274(a) bars deductions for certain entertainment-related expenses. Sec. 274(e) provides that the Sec. 274(a) deduction limit does not apply to expenses to the extent treated by the taxpayer as employee compensation on the taxpayer's return and as wages to the employee.

Congress provided specified valuation rates for certain benefits (including employer-provided flights on a noncommercial aircraft) in computing the income taxable to an employee. These rates do not correlate to the actual costs the employer incurred, but are intended to approximate coach and first-class fares on commercial airlines.

Sec. 274(e) was intended to remove certain deductions from Sec. 274. Thus, the Tax Court held that Sec. 274 did not apply; the employer's deduction was not limited to the amount the executives reported.

The court held that the IRS position was incorrect for several reasons, including: (1) the employees were properly taxed on the benefit; (2) Sutherland did not receive a tax-free benefit; (3) Sutherland did not deduct excess expenses under Sec. 162; and (4) the application of Secs. 274 and 162 may result in mismatched income and deductions. The IRS appealed.

Eighth Circuit's decision: Upholding the Tax Court, the Eighth Circuit merely stated that the Tax Court's decision was well reasoned and thorough.

This is the first appellate court decision on this topic. It provides strong support that a Sec. 162 deduction is the proper treatment of an employer's corporate-jet costs, as long as the employee recognizes imputed income for the vacation flights.

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(30) 2000 TNT 191-46.

(31) IRS Letter Ruling 200110025 (12/8/01).

(32) Notice 2000-56, IRB 2000-43, 393; see Rev. Proc. 92-64, 1992-2 CB 422, for the model grantor trust.

(33) TD 8883 (5/11/00, corrected 6/14/00).

(34) IRS Letter Ruling 200039028 (6/29/00).

(35) Rev. Rul. 55-747, 1955-2 CB 228.

(36) Notice 2001-10, IRB 2001-5, 459, revk'g Rev. Rul. 55-747, note 35 supra, and modifying Rev. Ruls. 66-110, 1966-1 CB 12 and 67-154, 1967-1 CB 11.

(37) Rev. Rul. 66-110, note 36 supra.

(38) Rev. Rul. 67-154, note 36 supra.

(39) IRS Letter Ruling (TAM) 9604001 (9/8/95).

(40) Notice 2000-38, IRB 2000-33, 174.

(41) Notice 2001-14, IRB 2001-6, 516, obsolet'g Rev. Rul. 71-52, 1971-2 CB 278, and modify'g Notice 87-49, 1987-2 CB 355.

(42) Rev. Rul. 71-52, note 41 supra.

(43) Notice 87-49, note 41 supra.

(44) Ann. 2000-97, IRB 2000-48, 557.

(45) Ann. 2001-7, IRB 2001-3, 357, amend'g Ann. 2000-97, note 44 supra.

(46) Rev. Rul. 2001-1, IRB 2001-9, 726.

(47) Mark Scully v. US Wats, Inc., 3d Cir., 2/1/01.

(48) William Aramony v. United Way of America, 2d Cir., 6/20/01, rev'g and rem'g 86 F.Supp.2d 199 (SDNY, 1999).

(49) Rev. Rul. 80-359, 1980-2 CB 136.

(50) See Erickson, Tax Clinic, "IRS Clarifies Rev. Proc. on Partnership Interest for Services," 32 The Tax Adviser 741 (November 2001).

(51) TD 8928 (1/9/01), amending TD 8812 (2/2/99, corrected 3/24/99).

(52) See 29 CFR. part 825 (Sections 825.100-825.800).

(53) ERISA Opinion Letter 2001-02A (2/15/01).

(54) Neonatology Associates, P.A., 115 TC No. 5 (2000).

(55) P. L. 106-554, Section 104.

(56) TD 8933 (1/10/01).

(57) Sutherland Lumber-Southwest, Inc., 255 F3d 495 (8th Cir. 2001), aff'g 114 TC 197 (2000).

Industry Codes/Names: BANK Banking, Finance and Accounting; BUSN Any type of business
Descriptors: Employee benefits--Laws, regulations, etc.; Executives--Salaries, benefits, etc.
Geographic Codes: 1USA United States
File Segment: LRI File 150